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ARTICLES

SEC Enforcement of the Foreign Corrupt Practices Act*

WALLACE L. TIMMENY**

INTRODUCTION

President Carter signed the Foreign Corrupt Practices Act (FCPA) on December 19, 1977.¹ The general purpose of the Act is to prevent the bribing of foreign government officials by companies or individuals subject to the laws of the United States and to require certain companies to comply with books and records and internal accounting control provisions. As will be seen, enforcement of the Act falls on the shoulders of the Securities and Exchange Commission (Commission) and the Department of Justice. With minor exceptions,² both the Commission and the Department have eschewed comment on enforcement questions that may arise under the Act. The hesitation to promulgate guidelines reportedly stems from a fear that guidelines would provide road maps for would-be violators.³ It has, however, been suggested that such guidelines may serve the legitimate purpose of clarifying matters for businessmen who are

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1. The Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78m(b)(2), 78dd-1 to 78dd-2 (Supp. I 1977).

Some helpful articles on interpretive and enforcement questions under the FCPA are: Atkinson, *The Foreign Corrupt Practices Act of 1977: An International Application of SEC's Corporate Governance Reforms*, 12 INT'L LAW. 703 (1978); Baruch, *The Foreign Corrupt Practices Act*, 57 HARV. BUS. REV. 32 (1979); Best, *The Foreign Corrupt Practices Act*, 11 REV. SEC. REG. 975 (1978).

2. The few official comments contained in SEC releases are discussed in the text accompanying notes 10 and 27 *infra*.

3. NEWSWEEK, Feb. 19, 1979, at 63.

now reluctant to seek foreign business because of the uncertainties created by the Act.⁴ Be that as it may, it is not the purpose of this paper to provide guidance on the government's prosecutorial priorities; it is, rather, to discuss legal issues arising from the enforcement of the Act in actions brought by the Commission.

THE FOREIGN CORRUPT PRACTICES ACT AND ITS ADMINISTRATION

Section 103 of the FCPA amends section 30 of the Securities Exchange Act of 1934 (Exchange Act) by adding section 30A, which prohibits issuers that register securities or file reports under the Exchange Act and persons acting on their behalf from bribing foreign government officials to obtain or retain business or direct business to any person.⁵ Section 104 of the FCPA extends the same prohibitions to certain individuals and to corporations, partnerships, and other business associations that are organized in the United States or have their principal place of business in the United States and that do not register securities or file reports under the Exchange Act.⁶ Section 102 of the FCPA adds section 13(b)(2) to the Exchange Act⁷ which subjects to recordkeeping and accounting controls requirements issuers that register securities or file reports under the Exchange Act.

On February 15, 1979, the Commission announced the adoption of two rules promulgated under the FCPA. Rule 13b2-1⁸ prohibits the falsification of books and records required to be kept under section 13(b)(2)(A). Rule 13b2-2⁹ prohibits any officer or director from making materially false or misleading statements or omitting to state any material facts to accountants or auditors in connection with audits or the preparation of filings required by the Exchange Act.¹⁰

The FCPA provides for dual administration of its provisions by the Commission and the Department of Justice. To enforce the

4. The Carter administration, through the Department of Commerce, has urged the Department of Justice to provide guidelines for the purpose of fighting inflation. This is apparently to encourage exports by American companies, although it is unclear to what extent, if any, guidelines would help fight inflation. Thus, we might expect the Department of Justice to break silence soon. See *Justice Is Reluctant, Guide on New Bribe Legislation*, Washington Post, Oct. 10, 1978, § D, at 7-9.

5. 15 U.S.C. § 78dd-1 (Supp. I 1977).

6. *Id.* § 78dd-2.

7. *Id.* § 78m(b)(2). It is important to note that the reach of section 13(b)(2) is not limited to foreign activities.

8. 44 Fed. Reg. 10,970 (to be codified in 17 C.F.R. § 240.13b2-).

9. *Id.* (to be codified in 17 C.F.R. § 240.13b2-2).

10. 16 SEC Docket 1143, [Current] FED. SEC. L. REP. (CCH) ¶ 81,959 (1979).

FCPA and related rules, the Commission may make use of its enforcement powers under section 15 of the Exchange Act (administrative proceedings), section 21 of the Exchange Act (investigative and injunctive authority) and rule 2(e) of the Commission's Rules of Practice.¹¹ In addition, the Commission may transmit evidence of possible violations to the Attorney General for criminal proceedings.¹² Section 104 of the FCPA empowers the Department of Justice to institute civil injunctive actions. But the FCPA does not provide the Department with civil investigative tools such as subpoena power. Thus, unless the Congress amends the FCPA to provide the Department of Justice with investigative powers comparable to the Commission's powers under section 21, the Department will be handicapped in its efforts to use the injunctive authority provided in section 104.

INJUNCTIVE ACTIONS TO ENFORCE SECTION 30A

If past performance is any guide, the Commission can be expected to bring most of its enforcement actions with respect to section 30A as injunctive actions under section 21(d) of the Exchange Act.¹³ The Commission is empowered to seek an injunction against future violations whenever it shall appear that any person is violating or is about to violate the Exchange Act or rules thereunder, and upon a proper showing a district court may grant a restraining order or a temporary or permanent injunction.¹⁴ In practice, the granting of a permanent injunction hinges on the findings of a violation and the likelihood of a future violation.¹⁵

The showing to establish a likelihood of a future violation will, of course, vary from case to case, but the Second Circuit Court of Appeals has in recent decisions carefully outlined the standards that should be considered by district courts in determining whether to grant injunctive relief. In *SEC v. Universal Major Industries*,

11. 17 C.F.R. § 201.2(e) (1978).

12. Exchange Act § 21(d), 15 U.S.C. § 78u(d) (1976).

13. The injunctive action is the most frequently used enforcement tool. In fiscal 1977 the Commission filed 166 injunctive actions. 1977 SEC ANN. REP. 325.

14. 15 U.S.C. § 78u(d). Two commentators have deplored the inattention of the Commission to the language "is" violating or "is about to" violate in section 21(d). Klein, *Response On SEC Consents . . . Process is Corrupting All*, Legal Times of Washington, June 26, 1978, at 20, col. 1; Mathews, *The SEC and Civil Injunctions: It's Time to Give the Commission an Administrative Cease and Desist Remedy*, 6 SEC. REG. L.J. (1979).

15. See generally *SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90 (2d Cir. 1978); *SEC v. Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972).

Inc.,¹⁶ and in *SEC v. Commonwealth Chemical Securities, Inc.*,¹⁷ the Second Circuit Court of Appeals suggests that before imposing a permanent injunction district courts consider the following factors:

- (1) whether the defendant's violation was an isolated incident or part of a pattern of recurring violations;
- (2) whether the violation was gross or egregious as opposed to technical;
- (3) the degree of scienter involved in the violation;
- (4) the steps taken by the defendant to remedy the violation;
- (5) the defendant's attitude at trial concerning the alleged violations; and
- (6) whether the defendant currently occupies or may occupy a position that will expose the defendant to future opportunities to violate the federal securities laws.

Substantial focus is likely on these issues in injunctive actions to enforce the FCPA, since the strict proscriptions of that Act, particularly the books and records provisions of section 13(b), may leave defendants little room to argue against the finding of a violation.

Standard of Proof

As noted, the first hurdle for the Commission in an injunctive action is proof to sustain a finding of a violation. In *Collins Securities Corp. v. SEC*,¹⁸ the Court of Appeals for the District of Columbia held that in an administrative proceeding involving proof of fraud by inference and a bar from the securities business, the standard of proof required was a clear and convincing standard as opposed to a preponderance of the evidence standard. The defendants in *SEC v. Savoy Industries*¹⁹ and *SEC v. Commonwealth Chemical Securities, Inc.*,²⁰ argued unsuccessfully that the clear and convincing standard should apply in injunctive actions. But the *Savoy* and the *Commonwealth* cases may not be the last word on this issue. The substantial collateral effects of an injunction that are identical or similar to the sanction involved in *Collins*, such as possible disqualification from association with a broker-dealer²¹ or automatic

16. 546 F.2d 1044, 1048 (2d Cir. 1976), *cert. denied sub nom.*, *Homans v. SEC*, 434 U.S. 834 (1977).

17. 574 F.2d at 100.

18. 562 F.2d 820 (D.D.C. 1977).

19. [1978] FED. SEC. L. REP. (CCH) ¶ 96,497 (D.D.C. 1978).

20. 574 F.2d 90 (2d Cir. 1978).

21. Exchange Act § 15(b)(6), 15 U.S.C. § 78o-4(c)(4) (1976).

disqualification from association with a registered investment company,²² may cause the standard of proof question to come up again in SEC injunctive actions.²³

Mental State of the Alleged Violator

Questions concerning standard of proof notwithstanding, the principal questions in any injunctive action usually involve the elements of the section allegedly violated. The most likely issue to be contested in actions to enjoin violations of section 30A will be the mental state of the alleged violator.²⁴ Section 30A prohibits payments or promises of payment made corruptly to any foreign official,²⁵ and the legislative history of the section indicates that the word "corruptly" connotes an evil motive or purpose.²⁶ The Commission, however, announcing the passage of the FCPA, pronounced that "a negligence standard will govern civil injunctive actions brought to enforce the Act."²⁷ Whether the Commission's running start on the issue proves to be effective remains to be seen. The Commission would justify the lower negligence standard by arguing that the Commission brings injunctive actions to protect the public from the harm that ensues from a violation of the securities laws. Thus, a court may properly focus on that harm and issue an injunction to protect the public based solely on the negligent conduct of a

22. Investment Company Act of 1940 § 9(a)(2), 15 U.S.C. § 80a-9(a)(2) (1976).

23. At the time *Savoy* and *Commonwealth* were decided, however, injunctive actions did not necessarily have a collateral estoppel effect on later actions for damages. See, e.g., *Rachal v. Hill*, 435 F.2d 59 (5th Cir. 1970). Subsequently, the Supreme Court in *Parklane Hosiery Co. v. Shore*, ___ U.S. ___, 99 S. Ct. 645 (1979), held that a defendant may not relitigate in a damage action issues of fact resolved in a prior SEC enforcement action against him. Although the standard of proof in damage actions parallels the standard in injunctive actions, the practical effect of *Shore* may be that defendants will seek to argue that the effect of collateral estoppel in a subsequent action for damages coupled with the collateral effects of an injunction now requires a showing of proof in the injunctive action at least as great as that employed in *Collins*.

24. In corrupt practices cases involving alleged payments to foreign officials, the use of the jurisdictional means in furtherance of the improper conduct may not be found and proved as easily as it is in other securities cases where the use of the mails or other instrumentalities of interstate commerce is commonplace and easily proven.

25. So-called "grease" payments to insure cooperation of customs officials and the like are omitted from the coverage of the FCPA by excluding from the definition of a foreign official "any employee of a foreign government . . . or instrumentality . . . whose duties are essentially ministerial or clerical." Exchange Act § 30A(b), 15 U.S.C. § 78dd-1(b) (Supp. I 1977).

26. SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, CORRUPT OVERSEAS PAYMENTS BY U.S. BUSINESS ENTERPRISES, S. REP. NO. 1031, 94th Cong., 2d Sess. 7 (1976).

27. SEC. EXCH. ACT RELEASE NO. 14478, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 72,264 (Feb. 16, 1978) (citing H.R. REP. NO. 640, 95th Cong., 1st Sess. 10 (1977)).

defendant, even if the language of the statute allegedly violated arguably may require some form of intentional conduct as an element of the violation.²⁸

There is an obvious parallel to the debate over whether scienter, that is, conduct involving "a mental state embracing intent to deceive, manipulate or defraud,"²⁹ is a necessary element in an action for injunctive relief under the anti-fraud provisions of section 10(b) and rule 10b-5.³⁰ The Court of Appeals for the Fifth Circuit focused on the Commission's policy argument to support injunctive relief and rejected it in the first appellate decision that squarely decided the scienter question in an SEC injunctive action.³¹ The Court of Appeals for the Second Circuit, however, accepted the policy argument, and cited the language of the legislative history of section 21(d) at the time of the Securities Acts Amendments of 1975: "[S]cienter, causation and the extent of damages are elements not required to be demonstrated in a Commission injunctive action."³² The court stated: "It would be difficult to find a clearer indication . . . that Congress intended to exempt SEC injunction actions from the scienter requirement applicable to private actions."³³

Even if the courts ultimately insist on a standard of intentional conduct in injunctive actions under section 30A, recklessness on the part of the defendants may meet that standard. Indeed, recklessness has been held sufficient to satisfy the scienter requirement in enforcement actions brought under section 10(b) and rule 10b-5.³⁴ A

28. See HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, UNLAWFUL CORPORATE PAYMENTS ACT OF 1977, H.R. REP. NO. 640, 95th Cong., 1st Sess. 10 (1977).

29. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-94 n.12 (1976). Since the Supreme Court's decision in *Hochfelder*, some lower courts have held that knowing participation in unlawful conduct in the sense that one intended to act as opposed to negligent action was sufficient to satisfy a scienter requirement. See, e.g., *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976). Other courts have held that the conduct must not only be knowing in that sense but also must include an intent to harm the defendant. See, e.g., *SEC v. Am. Realty Trust*, 429 F. Supp. 1148, 1171 (E.D. Va. 1977), *rev'd on other grounds*, 586 F.2d 1001 (4th Cir. 1978).

30. This question was, of course, left open by the *Hochfelder* opinion. 425 U.S. at 194 n.12.

31. *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978).

32. *SEC v. Aaron*, [Current] FED. SEC. L. REP. (CCH) ¶ 96,800, at 95,131 (2d Cir. 1979); cf. *SEC v. Am. Realty Trust*, 586 F.2d 1001 (4th Cir. 1978) (accepting the Commission's policy approach with regard to an injunction against future violations of section 17(a) of the Securities Act of 1933, 15 U.S.C. § 76q(a) (1976)).

33. *SEC v. Aaron*, [Current] FED. SEC. L. REP. at 95,131.

34. See generally *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, ___ U.S. ___, 47 U.S.L.W. 3586, *reh. denied*, 47 U.S.L.W. 3699 (U.S. 1979); cf. *Rolf v. Blythe, Eastman, Dillon & Co.*, 570 F.2d 38, *cert. denied*, ___ U.S. ___, 99 S. Ct. 642 (1979) (recklessness will suffice to establish scienter in an action for damages).

recklessness versus negligence analysis is most likely to develop under section 30A(a)(3) which deals with payments or promises to "any person, while knowing or *having reason to know* that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official, to any foreign political party or official thereof, or to any candidate for foreign political office" for prohibited purposes. (Emphasis added).

The "reason to know" standard suggests that the issuer cannot ignore "red flags," that is, indications that would lead the reasonable person to believe something may be amiss. After being put on notice, will the failure to investigate constitute negligence or recklessness? The failure to investigate in the presence of danger signs should suffice to establish recklessness, and, concomitantly, liability under section 30A(a)(3), assuming all other elements of a violation are present.³⁵

Even absent red flags, in light of the obligations imposed by the FCPA, the failure to investigate material matters may suffice to establish a "reckless" standard based on "conscious avoidance." The Second Circuit Court of Appeals, in *United States v. Hanlon*, stated: "One may not deliberately close his eyes to what otherwise would have been obvious to him."³⁶ Just as the failure to investigate in the presence of red flags may result in liability, so too, the failure to investigate *for* red flags may result in liability. Thus, the prudent approach would be to conduct some investigation even though there are no danger signs.

This message should not be misread. It is offered not to enlist volunteers in an SEC crusade, but rather to highlight the opportunity to establish good faith, a key issue in an injunctive action. Lack of good faith compliance may not only give rise to violations but also bears importantly on the availability of injunctive relief.³⁷ In addition, the development of a stronger competitive position may result from this prudence. The benefits to be gained are analogous to the

35. Red flags in corrupt practices cases will, of course, vary from case to case. A red flag might be merely doing business in certain countries where bribes are a way of life, having to switch agents to close a deal, or having to pay a commission that is excessive. See Hehmyer, *Government Complicity in Payments?*, Wall St. J., Oct. 16, 1978, at 26, col. 4. The author, in this letter to Philip Heymann of the Department of Justice, states that he was present at a meeting during which officials of the government of the United States advised businessmen that "under-the-table payments" to government officials in the Middle East were customary.

36. 548 F.2d 1096, 1100 n.7 (2d Cir. 1978). *Hanlon* did not involve charges under the federal securities laws. The principal charges were wire fraud and false statements to obtain loans from a federally insured bank.

37. See text accompanying notes 16 and 17 *supra*.

benefits that result from a trading suspension,³⁸ which over the short term may cause discomfort to a company whose securities have been suspended. Over the long term, the company and certainly the marketplace will be stronger as a result of the suspension. Further, investigation in the ordinary course of business may uncover information that will cause a company to turn away business. Although causing some short-term discomfort, over the long term the company will develop strength because it will compete based upon the quality of its product and because it will develop a reputation for integrity.

Obtaining, Retaining or Directing Business

To fall within the proscription of section 30A, a payment or a promise to pay must be made to assist in obtaining, retaining or directing business to any person. In focusing on these proscriptions, the 95th Congress adopted what may seem to be a narrower standard than that considered by the 94th Congress which would have also covered payments to influence legislation or regulations.³⁹ However, under many circumstances, payments to obtain favorable regulatory rulings or legislation may well be covered by the FCPA. This may occur in a number of ways. First, in many cases relief from regulations may result in assisting a company to obtain or retain business. Consider, for example, attempts at relief from export taxes by an exporter of raw materials. Obtaining lower export taxes from a foreign country in order to reduce the cost of raw materials may enable it to undersell competitors. Thus, payments to obtain relief from export taxes may assist in retaining business. Likewise, payments to obtain lower import taxes on sales in a foreign country may be designed to improve the importer's competitive position and thus assist it in obtaining or retaining business in that country. Although all may not agree with these interpretations, it is clear that Congress, by using the words "to assist" in referring to obtaining, retaining or directing business, intended a broad reach for those provisions of the Act.⁴⁰

Second, a payment to obtain favorable action on a statute or a regulation that confers substantive benefits on one company, that is, something equivalent to a private statute, will most likely also be covered by section 30A. For example, in January 1976, the Com-

38. See Exchange Act § 12k, 15 U.S.C. § 78(1)(k) (1976).

39. Atkinson, *supra* note 1, at 27 n.50.

40. Exchange Act § 30A(a)(1)(B), 15 U.S.C. § 78dd-1(a) (Supp. I 1977).

mission alleged that United Brands had paid \$2.5 million to high government officials of the Republic of Honduras to obtain relief from export taxes on bananas.⁴¹ The complaint alleged that the export taxes would have a material adverse effect on the operations of United Brands. There should be no question that payments such as those allegedly made by United Brands to obtain relief from legislation that would adversely affect its business are payments to obtain or retain business. Proof that the payment was to alleviate an adverse effect on the company's operations, provided that effect is material, should suffice to establish the violation.

Finally, there is still the question of disclosure as illustrated by the United Brands case. Some may consider it too great a stretch to suppose that the FCPA covers payments to obtain relief from export or import duties or similar regulations or legislation. Nevertheless, where such payments are material, the disclosure provisions of the federal securities laws will apply.

Materiality in the disclosure context, of course, is not limited to a material effect on the company's earnings. In its report to Congress on questionable payments, the Commission noted that materiality in the disclosure context may be demonstrated by, among other things, the following:

- (1) the falsification of corporate books and records;
- (2) the recipients of the payments;
- (3) the knowledge or participation of corporate management;
- (4) the effect on the corporation's business (including the effect of cessation on earnings or the potential for expropriation); and
- (5) the legality of the payment under local law, and the amount of the payment.⁴²

INJUNCTIVE ACTIONS TO ENFORCE THE RECORDKEEPING PROVISIONS OF THE FCPA AND RELATED RULES

Materiality

The concept of materiality is likely to be a focal issue in most injunctive actions alleging noncompliance with section 13(b)(2)(A) and rule 13b2-1. Neither the section nor the rule contains the word "material." The American Bar Association Guide to section 13(b)(2) (Guide)⁴³ discusses the section in terms of "errors" (inaccu-

41. SEC Litigation Release No. 7251, SEC Docket 1141 (1976).

42. See generally SEC REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES (1976) [hereinafter cited as SEC REPORT ON QUESTIONABLE PAYMENTS].

43. Comm. on Corporate Law and Accounting of the ABA, *A Guide to the New Section*

racies resulting from unintentional conduct) and "irregularities" (inaccuracies resulting from intentional conduct). The Guide suggests that a person who intentionally falsifies records places "himself in jeopardy under the penalty provisions of section 32(a) of the 1934 Act . . . [and] [t]he accounting concept of materiality is not relevant to such a violation."⁴⁴ Section 32(a) concerns criminal penalties. Presumably, in a remedial injunctive action involving intentional falsification of records, the authors of the Guide would concede that the "accounting concept of materiality" is again not relevant to a finding of a violation.

Where the inaccuracies result from "errors" (unintentional conduct), the Guide suggests a violation of section 13(b)(2)(A) may have occurred "if an issuer's books and records contain errors of a magnitude that renders them material according to traditional standards of accounting, and the mistaken entries are used as a basis for the preparation of financial statements"⁴⁵ Next the Guide suggests that, even if an error material in the traditional accounting sense has been made, where it is corrected before it appears in the issuer's financial statements a "successful defense" should be available to a section 13(b)(2)(A) charge.⁴⁶ Furthermore, the Guide argues that where there is no intentional conduct, immaterial inaccuracies should not constitute a violation of section 13(b)(2)(A).⁴⁷

No one should argue with a suggestion that the Commission, before instituting an injunctive action, ought to consider efforts to correct errors. But there is no basis for engrafting to section 13(b)(2)(A) the concept of materiality "according to traditional standards of accounting." The Congress was confronted with widespread breakdowns in corporate accounting systems, and some of the most egregious problems involved off-the-books slush funds that were not material in the traditional accounting sense because the slush funds were dwarfed by the assets and earnings of the corporations. The Congress also had before it the record of enforcement actions brought by the Commission.⁴⁸ In these actions, the complaints alleged that the defendants failed to disclose inaccurate

13(b)(2) Accounting Requirements of the Securities Exchange Act of 1934 (Section 102 of the Foreign Corrupt Practices Act of 1977), 34 Bus. Law. 307 (1978).

44. *Id.* at 315.

45. *Id.*

46. *Id.*

47. *Id.*

48. See generally SEC REPORT ON QUESTIONABLE PAYMENTS, *supra* note 42.

books and records. Not one complaint alleged that the inaccuracies were material in the traditional accounting sense. Moreover, many corporate defendants consented to the entry of an injunction containing a paragraph in the decree enjoining them from making false entries on their books and records "material in *nature, amount or effect*,"⁴⁹ language specifically designed to go beyond the notion of materiality in the traditional accounting sense.

Commentators on rule 13b2-1 during the proposal period urged the Commission to limit the application of the rule to material falsifications of corporate books and records.⁵⁰ The Commission declined to so limit the rule noting that the concept of " 'material' falsifications of corporate books and records." The Commission declined to so limit the rule noting that the concept of " 'material' in its release announcing the adoption of rule 13b2-1 suggested that the presence of the words " 'in reasonable detail' in section 13(b)(2)(A) should alleviate much of the concern expressed in comments concerning" the proposed rule.⁵² As noted in the Commission's release, those words were inserted in section 13(b)(2)(A) by the Conference committee to alleviate concerns that the section would require a degree of perfection unattainable in practice.⁵³ But the committee went on to explain that the "reasonable detail" amendment was intended to make "clear that the issuer's records should reflect transactions in conformity with accepted methods of recording economic events and effectively prevent off-the-books slush funds and payments of bribes."⁵⁴ The committee's explanation highlighting its goal of limiting off-the-books slush funds and bribes, coupled with the knowledge that the Congress had considered many slush fund and bribe cases not limited by the concept of materiality "according to traditional standards of accounting" weighs against the approach by the Guide. But the most compelling argument against the inclusion of the materiality concept in the books and records provisions is that Congress did not see fit to use the term "material" in section 13(b)(2), and, manifestly, when

49. See, e.g., *SEC v. Exxon Corp.*, [1977] SEC. REG. & L. REP. (BNA) A-20 (D.D.C. 1977); *SEC v. Lockheed Airways Corp.*, [1977] SEC. REG. & L. REP. (BNA) A-3 (D.D.C. 1976).

50. 16 SEC Docket, *supra* note 10, at 1150, [Current] FED. SEC. L. REP. at 81,397.

51. *Id.* at 1151, [Current] FED. SEC. L. REP. at 81,397-98.

52. *Id.*

53. *Id.*

54. HOUSE CONFERENCE COMM., FOREIGN CORRUPT PRACTICES, H.R. REP. NO. 831, 95th Cong., 1st Sess. 10, reprinted in [1977] U.S. CODE CONG. & AD. NEWS 4121, 4122.

Congress intended to use the term in the securities laws, it did so, including the use of the term twice in section 13.⁵⁵

Scienter

The Guide rejects the possibility that a repeated pattern of errors might be a violation of section 13(b)(2)(A) because "no element of intent would be present." Legislative history presents a compelling argument that the Guide is incorrect. The books and records provisions considered by the Senate included provisions that paralleled the Commission's present rules 13b2-1 and 13b2-2 concerning falsification of books and records and false statements to accountants. These provisions as considered by the Senate included the term "knowingly." However, as a result of the presence of a scienter requirement, those provisions were dropped from the Senate bill.⁵⁶ Thus, a scienter requirement was considered in the context of section 13(b) and, by design, was not included in the statute as passed. Again the Commission in announcing the adoption of rules 13b2-1 and 13b2-2 indicated it had considered and rejected the suggestions of commentators to include the scienter requirement in the rules as adopted. The Commission urged that the inclusion of a scienter requirement in the rules would be inconsistent with the language in section 13(b)(2)(A).⁵⁷

There may be more room for argument on the necessity of scienter as an element in injunctive actions alleging violations of rule 13b2-1. Under the rule, "no person shall, directly or indirectly, falsify or cause to be falsified" books and records subject to section 13(b)(2)(A). In dissenting from the adoption of the rule, Commissioner Karmel noted that the term "falsify" implies an element of deceit.⁵⁸ Although not cited by the Commissioner, there is an obvious parallel to the Supreme Court's observation in *Ernst & Ernst v. Hochfelder* that "[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that §10(b) was intended to proscribe knowing or intentional miscon-

55. Exchange Act §§ 13(b)(2), 13(g)(2), 15 U.S.C. §§ 78m(d)(2), 78m(g)(2) (1976 & Supp. I 1977).

56. HOUSE CONFERENCE COMM., *supra* note 54, at 10-11, [1977] U.S. CODE CONG. & AD. NEWS at 4122-24. The Conference committee dropped a companion provision to section 13(b)(2)(A) that would have prohibited the falsification of books and records because it decided "that this legislation should not be converted into a debate on the important issues raised by the *Hochfelder* decision." *Id.* at 11, [1977] U.S. CODE CONG. & AD. NEWS at 4123.

57. 16 SEC DOCKET, *supra* note 10, at 1151, [Current] FED. SEC. L. REP. at 81,398.

58. *Id.* at 1155, [Current] FED. SEC. L. REP. at 81,401.

duct."⁵⁹ But in *Hochfelder*, the Supreme Court did not have the benefit of the explicit intent of Congress on the meaning of the terms used in section 10(b).⁶⁰ In contrast, the Commission has expressed its intent not to include a scienter requirement in rule 13b2-1, and the Commission notes that its view is not inconsistent with section 13(b)(2)(A).⁶¹

Corrections as Admissions

The Guide cautions against a possible unwelcome consequence of the passage of section 13(b)(2)(A):

No interpretation of the new accounting provisions of section 13(b)(2) could be more shortsighted or self-defeating than one that would lead companies to be afraid to correct discovered errors for fear that the correction itself would constitute an admission of violation of the statute and would later be used against the company as a basis for imposing liability upon it.⁶²

This observation is seriously misleading. A company has no choice but to correct errors; to do otherwise would be to fail to comply with the mandate in section 13(b)(2) to make and keep accurate books and records. But more to the point, the tacit assumption behind the concern is that the statute will be administered by automatons. No prosecutor could state that every correction will result in absolute protection from prosecution. The circumstances of a case may dictate the necessity for an action even when corrections have been made, and this is especially true with respect to civil injunctive actions. Nevertheless, anyone with responsibility for recommending enforcement action must consider ameliorative steps taken by the subject of an investigation, and those steps may properly be the basis for recommending against enforcement action. The solution to the dilemma perceived by the Guide lies not in engrafting to the statute interpretive exemptions that frustrate congressional intent and eliminate protections for the public. Rather,

59. 425 U.S. at 197.

60. *Id.* at 196.

61. Although not articulated in the Commission's release, this latter statement anticipates an argument based on the holding of the Supreme Court in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). In *Santa Fe* the Court held that if rule 10b-5 were interpreted to cover conduct not involving manipulation or deception, the coverage of the rule would exceed the breadth of section 10(b). The wording of section 13(b)(2)(A) would seem to preclude a similar argument in this context. But if one can somehow find a scienter requirement in section 13(b)(2)(A), it follows that it should also be found in rule 13b2-1.

62. Comm. on Corporate Law and Accounting of the ABA, *supra* note 43, at 316.

the solution lies in utilizing the protections provided by the Commission's procedures for participants in an investigation. On the part of a proposed defendant or respondent, this means vigorously bringing ameliorative factors to the attention of the Commission's staff during the investigation, and, if advocacy at the staff level fails, submitting argument to the Commission in what is commonly called a "Wells submission."⁶³ The Commission carefully reviews all recommendations for enforcement, and it is safe to say that one of the more significant factors that may weigh in favor of a proposed defendant or respondent is that the problem was corrected and brought forward by that person.

INJUNCTIVE ACTIONS BROUGHT BY THE COMMISSION CHARGING VIOLATIONS OF THE FCPA

The Commission has brought three injunctive actions to enforce the FCPA. In *SEC v. Aminex Resources Corp.*⁶⁴ the Commission alleged that Aminex, certain officers, and certain controlled corporations had misappropriated \$1.24 million of the corporate assets of Aminex. An Aminex officer allegedly created a corporation and caused Aminex to pay that corporation for engineering services that were never performed. The complaint also charged that the same officer sold a boat owned by Aminex and diverted to himself the profits of the sale. In addition, officers of Aminex allegedly caused Aminex to pay them \$110,000 in one instance and \$30,000 in another instance without proper corporate authorizations and allegedly caused the corporation to falsely record the unauthorized payments as administrative fees. All the alleged misconduct took place within the United States. The Commission charged that the facts alleged in the complaint constituted a failure to comply with the books and records requirements of section 13(b)(2)(A) and a failure to comply with the internal control requirements of section 13(b)(2)(B). *Aminex* was the first case brought by the Commission under the FCPA, and it illustrates that the Commission will allege violations of section 13(b)(2), although there is no foreign involvement of any kind.

63. 17 C.F.R. § 202.5(c) (1978).

64. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,352 (D.D.C. 1978). All the defendants, with the exception of Aminex Resources and its subsidiaries, consented to the entry of injunctions without admitting or denying the Commission's allegations. *SEC v. Aminex Resources Corp.*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,458 (D.D.C. 1978).

In *SEC v. Page Airways*⁶⁵ the Commission alleged that a Page subsidiary contracted to operate and service aircraft that had been sold to a foreign country. The subsidiary allegedly, from at least December 19, 1977, to the date of the filing of the complaint (April 12, 1978), failed to record on its books, receipts and disbursements of the cash received for its services. The complaint also alleged that certain transactions were effected without adequate documentation and accounting controls sufficient to ensure that expenditures made by the Page subsidiary were made for the purpose indicated on the company's books and records. The complaint alleged that the conduct of Page constituted a continuing failure to make and keep records in accordance with section 13(b)(2)(A) and a failure to devise and maintain a system of internal accounting controls as required by section 13(b)(2).

In *SEC v. Katy Industries, Inc.*,⁶⁶ the Commission alleged that Katy's agreement to pay to a consulting corporation controlled by Katy's agent and a representative of an Indonesian government 13.33 percent of Katy's profits from oil production in Indonesia resulted in a violation of section 30A. The Commission alleged that in 1974, 1975, and 1976, approximately \$200,000 was paid to the consulting corporation by Katy for the benefit of the government official. Although no payments were made after May 1976, the agreement allegedly continued until at least July 28, 1978, when Katy terminated it by letter. The Commission alleged that the agreement constituted a promise to pay in violation of section 30A. The allegations illustrate that the Commission may take the view that acts which occurred prior to the passage of the FCPA may have a continuing effect after the passage of the Act. The Katy allegations do not involve a retroactive application of the FCPA.⁶⁷

In a similar vein, the provisions of section 13(b)(2) requiring an issuer to "make and keep" accurate records may raise the question of the obligation of an issuer to correct inaccuracies in the books and records that were recorded prior to the FCPA. Presumably the obligation to keep accurate books and records will require an issuer to make such corrections. However, this need not entail correcting

65. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,393 (D.D.C. 1978). Subsequently, this case was transferred to the Western District of New York. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,717 (D.D.C. 1978).

66. 15 SEC Docket 891 (N.D. Ill. 1978).

67. The Supreme Court has held that a civil statute will not be applied retroactively unless there is a clear mandate from the legislature to do so. *Greene v. United States*, 376 U.S. 149, 160 (1964). There would appear to be no such mandate in the FCPA.

every journal entry or record that was incorrect. If the conduct which led to the inaccurate entries has been terminated and described in a disclosure document together with disclosure of the fact that the books and records in question were inaccurate, that should suffice to satisfy the provision of the statute requiring the issuer to make and keep accurate books and records.⁶⁸

ADMINISTRATIVE PROCEEDINGS UNDER SECTION 15(c)(4) OF THE EXCHANGE ACT

In addition to injunctive actions, administrative proceedings under section 15(c)(4) of the Exchange Act should figure prominently in the enforcement of the FCPA. Section 15(c)(4) was not amended by the passage of the FCPA, but that section provides the Commission with the authority, after notice and opportunity for hearing, to order any person subject to the provisions of sections 12, 13 or subsection (d) of section 15, or any rule or regulation thereunder to comply with any such provision, rule or regulation upon such terms and conditions and within such time as the Commission may specify in an order. Since the books and records and controls provisions of the FCPA were made part of section 13 in the Exchange Act, section 15(c)(4) would seem to give the Commission the power to require compliance with section 13(b) and the rules thereunder on such terms and conditions as the Commission may order.

A recent section 15(c)(4) proceeding illustrates the Commission's approach to imposing terms and conditions that may become more common with the advent of the FCPA. *In re Hycel, Inc.*,⁶⁹ involved an allegation that Hycel, in filings with the Commission, failed to disclose that the chairman of the board had used corporate funds for his personal benefit. The corporation, without admitting or denying the allegations, consented to findings of violations solely for the purposes of the section 15(c)(4) proceeding. The Commission found that Hycel had failed to maintain an adequate internal control system and that the board of directors bore part of the responsibility for the company's lack of internal controls. The Commission ordered Hycel to comply with its undertaking to ensure that its audit committee would be made up of independent directors and would review compliance procedures designed to prevent the misuse of corporate funds. The Commission also ordered the company to

68. There may be an obligation to disclose that books and records were false wholly apart from the obligations created by section 13(b)(2). See text accompanying note 41 *supra*.

69. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,676 (1978).

comply with its undertaking to require the audit committee to report to the Commission any deviation from the procedures adopted as part of the settlement to prevent future violations. It is not a big step to go from ordering compliance with terms and conditions in undertakings to ordering directly the same terms and conditions.

Individual Liability in section 15(c)(4) Proceedings

A Commission official has said that the Commission's ability to order a sanction in a section 15(c)(4) proceeding may be "virtually boundless."⁷⁰ Does the absence of bounds extend to naming individuals as respondents in section 15(c)(4) proceedings? To date, the Commission has not included the name of any individual in the caption of a section 15(c)(4) proceeding. However, in the *Hycel* case, and in a section 15(c)(4) proceeding involving the filings of Metro-Goldwyn-Mayer, Inc.,⁷¹ individuals who had been associated with an issuer were discussed by name in the proceedings and the conduct of the individuals which related to the alleged nondisclosures was dealt with by the Commission's acceptance of an undertaking from the individuals, which was referred to in the body of the section 15(c)(4) order.

In a recent administrative proceeding brought pursuant to sections 15(c)(4) and 21(a) of the Exchange Act, the Commission named an individual as well as an issuer in the caption.⁷² In a dissenting opinion, Commissioner Karmel questioned the Commission's authority to bring an administrative proceeding against an individual under section 15(c)(4), noting that the language of the section and its legislative history indicates that the Commission requested the enactment of the section in order to provide it with authority to correct filings under sections 12, 13 and 15(d).⁷³ Commissioner Karmel is also of the view that the authority granted to the Commission in section 21(a) does not empower the Commission to bring an administrative action against an individual.⁷⁴ In *In re GEICO*,⁷⁵ there is also a reference to individuals in the context of a proceeding brought pursuant to section 15(c)(4) and section 21(a). But all of the administrative actions referring to individuals under

70. Accounting Provisions of Foreign Corrupt Practices Act Discussed at New York Law Journal Seminar, [1978] SEC. REG. & L. REP. (BNA) D-1, D-2 (May 3, 1978).

71. *In re Metro-Goldwyn-Mayer, Inc.*, 7 SEC Docket 866 (1975).

72. *In re Spartek, Inc.*, and John A. Cable, 16 SEC Docket 1094 (1979).

73. *Id.* at 1102.

74. *Id.*

75. 10 SEC Docket 790 (1976).

section 15(c)(4) or in a combined proceeding under 15(c)(4) and section 21(a) have been resolved on the basis of consents on the part of the parties involved. Thus, there has been no litigated precedent for the inclusion of an individual in administrative proceedings under section 15(c)(4).

VICARIOUS LIABILITY UNDER THE FCPA

The liability of issuers for the acts or failures of foreign or domestic subsidiaries is not clearly specified in section 30A and section 13(b). Section 30A covers the conduct of registered and reporting companies and the conduct of any officer, director, employee, or agent of any such company or any stockholder of such company acting on behalf of the company. Thus, by its terms, section 30A does not refer to subsidiaries whose securities are not registered or which are not required to file reports pursuant to section 15(d). The legislative history of section 30A indicates that the section was not intended to cover the activities of foreign subsidiaries where there was no jurisdictional nexus with the United States and where the issuer of a reporting company had no knowledge of the payment.⁷⁶ In discussing the liability of domestic concerns the Conference committee report stated:

[T]he conferees recognized the inherent jurisdictional, enforcement, and diplomatic difficulties raised by the inclusion of foreign subsidiaries of U.S. companies in the direct prohibitions of the bill. However, the conferees intend to make clear that any issuer or domestic concern which engages in bribery of foreign officials indirectly through any other person or entity would itself be liable under the bill.⁷⁷

Thus, Congress intended section 30A(a)(3) to apply to the activities of foreign subsidiaries in certain circumstances.⁷⁸

76. SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, FOREIGN CORRUPT PRACTICES ACT OF 1977, S. Rep. No. 114, 95th Cong., 1st Sess. 11, *reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 4098, 4109.

77. HOUSE CONFERENCE COMM., *supra* note 54, at 14, [1977] U.S. CODE CONG. & AD. NEWS at 4126.

78. The Conference committee also stated that jurisdictional, enforcement, and diplomatic difficulties may not be present in the case of individuals who are U.S. citizens, nationals, or residents. Therefore, individuals other than those specifically covered by the bill (*e.g.*, officers, directors, employees, agents, or stockholders acting on behalf of an issuer or domestic concern) will be liable when they act in relation to the affairs of any foreign subsidiary of an issuer or domestic concern if they are citizens, nationals, or residents of the United States. In addition, the conferees determined that foreign nationals or resi-

In this connection, section 20(a) of the Exchange Act will no doubt be brought to bear in FCPA enforcement matters. Section 20(a) governs the conduct of controlling persons.⁷⁹ It has been argued that since the section states that controlling persons will be liable to any person to whom controlled persons are liable, its application should be limited to damage actions. Nonetheless, section 20(a) has been applied in SEC enforcement actions.⁸⁰

Aiding and Abetting

Section 20(a) provides a defense for a controlling person who acted "in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." This good faith defense has led to Commission reliance in enforcement actions on the concept of aiding and abetting, since, in theory, one may be negligent yet act in good faith, and it may be argued that one may aid and abet through negligence. In addition, aiding and abetting has often been used to ascribe liability to second level participants (other than control persons) such as lawyers, accountants or others who render material assistance to the primary violator in connection with the violation. Whether one can aid and abet violations of the Securities Exchange Act of 1934 in the context of a civil action was questioned in the *Hochfelder* case and specifically left open by the Supreme Court.⁸¹ Since *Hochfelder*, courts in SEC enforcement actions have continued to find liability based on aiding and abetting. But whether the appropriate standard governing liability should be based upon aiding and abetting through negligence or aiding and abetting with knowledge remains much in question. In *SEC v. Coven*⁸² the Second Circuit in the context of a violation of section 17(a) of the Securities Act of 1933 held that since a primary violator

dents otherwise under the jurisdiction of the United States would be covered by the bill in circumstances where an issuer or domestic concern engaged in conduct proscribed by the bill.

Id.

79. For a definition of "control," see 17 C.F.R. § 240.12b-2(b) (1978).

80. See *SEC v. Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *SEC v. First Sec. Co. of Chicago*, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972). *Contra SEC v. Coffey*, 493 F.2d 1304 (6th Cir.), *cert. denied*, 420 U.S. 908 (1974).

81. 425 U.S. at 191. For an excellent discussion on aiding and abetting, see Ruder, *Multiple Defendants In Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. Pa. L. Rev. 597 (1972).

82. 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, ____ U.S. ____, 47 U.S.L.W. 3586, *reh. denied*, 47 U.S.L.W. 3699 (U.S. 1979).

may violate section 17(a) by virtue of negligence, there was no reason why knowledge or scienter should be a necessary element of aiding and abetting such a violation.⁸³ The Second Circuit stated that the standard to be applied in determining whether one aids and abets is "whether an alleged aider and abettor 'should have been able to conclude that his act was likely to be used in furtherance of illegal activity,' in light of all the circumstances."⁸⁴ The circumstances to be considered in determining whether a defendant should have been able to conclude he was furthering illegal activity were the nature of the defendant's assistance, his awareness of the illegal scheme, his participation, and his duty to investigate.⁸⁵

In contrast, the Sixth Circuit has applied a more stringent definition of aiding and abetting. In *SEC v. Coffey*⁸⁶ the court held that one may aid and abet if he has a "general awareness that his role was part of an overall activity that is improper, and [that he] knowingly and substantially assisted the violation."⁸⁷

*Liability for a Subsidiary's Inaccurate Books
and Records or Inadequate Controls*

The Guide suggests that section 13(b) will apply to a subsidiary or an investee of an issuer only if that entity's financial statements are material to the issuer's financial statements.⁸⁸ The Senate committee comments on Senate Bill 305 do not place the same limitations on section 13(b) stating, "under the accounting section no off-the-books accounting fund could be lawfully maintained, either by a U.S. parent or by a foreign subsidiary"⁸⁹ Congress clearly did not intend to limit an issuer's responsibility to matters reflected in its financial statements. The conduct the Congress intended to outlaw through the FCPA frequently involved subsidiaries whose books and records were falsified to create the slush funds that were used to make questionable or illegal payments. It is unreasonable to suppose that Congress intended that issuers could continue such activities and escape liability by funneling the corrupt practices through a subsidiary. Certainly it is appropriate in determining an

83. *Id.* at 1028.

84. *Id.* (citation omitted).

85. *Id.*

86. 493 F.2d 1304 (6th Cir.), *cert. denied*, 420 U.S. 908 (1974).

87. *Id.* at 1316 (emphasis added).

88. Comm. on Corporate Law and Accounting of the ABA, *supra* note 43, at 310.

89. S. REP. No. 114, 95th Cong., 1st Sess. 11, *reprinted in* [1977] U.S. CODE CONG. & AD. NEWS 4098, 4109.

issuer's liability for inaccuracies in the books and records of a subsidiary or for insufficient controls in a subsidiary to look to the provisions of the rules relating to control under the Exchange Act or to relevant accounting principles. For example, rule 1-02(g) under regulation S-X defines control as "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership or voting shares, by contract, or otherwise,"⁹⁰ and the accounting profession recognizes that a company should account for a subsidiary on an equity basis if it has less than 50 percent ownership and exercises a significant influence over the subsidiary.⁹¹ Whether an issuer is in a position to direct the policies of or exert a significant influence on a subsidiary or an investee will, of course, be a factual matter. It will be possession of the power to direct policies or to exercise a significant influence—not the exercise of that power or the exercise of that influence—that will trigger liability for the acts of subsidiaries or investees under section 13(b).

CONCLUSION

As a nation we understand the implications of corrupt practices. Improper or questionable payments undermine our foreign policy and, in fact, place control of foreign policy in the hands of private individuals or companies who do not respond to the electorate. Corrupt practices can topple friendly governments, increase hostility to the United States, and provide ammunition to those who would topple our own system. Shoddy accounting practices foster those problems and result in significant detriment to individual investors, and to the marketplace in general, by undermining inves-

90. 17 C.F.R. § 210.1-02(g) (1978). See also 17 C.F.R. § 240.12b-2(f) (1978).

91. FASB FINANCIAL ACCOUNTING STANDARDS, OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD, No. 18 (1971) (original Pronouncements as of July 1, 1977). If a company were to account for an investment in another company in consolidated financial statements or by the equity method, an inference of control may be drawn from those accounting choices. For example, the Accounting Principles Board, discussing accounting for an investment by the equity method, has concluded that

an investment . . . of 20% or more of the voting stock of an investee should lead to a presumption that in the absence of evidence to the contrary an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20% of the voting stock of an investee should lead to a presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated.

Id. at 277. Having chosen to consolidate or account for an investment by the equity method, a company should have concluded it has the ability to exercise significant influence over an investee.

tor confidence. The problems leading to the passage of the FCPA have been more than sufficiently illumined in legislative history and in enforcement actions brought by government agencies. Against this background, it is unlikely that the courts will interpret the FCPA narrowly.